TAX EFFICIENT LUMP SUM INVESTMENTS

The following notes are designed to explain the principles behind the current range of tax efficient investment planning opportunities. The explanations are designed to give an over view of each product. Frequently, products delve into the esoteric limits of tax planning. Our notes are, therefore, a taster and no action should be taken without reference to your taxation and (where appropriate) legal advisers.

For 90% of clients there are much simpler and safer ways to defer and avoid taxes (pensions for instance), nonetheless very occasionally one of the following may be appropriate.

The following index may be helpful:

SCHEME **PAGE**

1. THE SEIS, EIS AND VCT REGIMES

1.1 Enterprise Investment Schemes (EIS)

EIS legislation replaced the business expansion scheme (BES) provisions and came into effect in January 1994. There was substantial revision of the rules in 1998 and 2004.

The investment is made into a qualifying unquoted trading company. To be “quoted” a company has to be on the main stock market, hence shares that are traded on the OFEX (Off Exchange) and Alternative Investment Market (AIM) still qualify for the EIS tax relief.

1.2 Venture Capital Trusts (VCTs)

A VCT structure is similar in many ways to an investment trust. The VCT is a quoted company which, in turn, invests in qualifying companies under the EIS legislation. Only new issue shares in a VCT qualify for tax relief.

In order to qualify and thus allow an investor to receive the tax benefits applicable to VCTs, a trust must fulfil the following criteria:

- Within 3 years, at least 70% of the trust's investments must be held in qualifying investments; that is newly issued shares or securities in qualifying companies.

- A minimum of 30% of the qualifying investments of the trust must be in ordinary shares of qualifying companies.

- A maximum of 15% of the VCT may be invested in 1 company. No more than £1 million per annum may be invested in any 1 qualifying company.

- The trust's income is wholly, or mainly from shares or securities.

- The trust must not retain more than 15% of the income derived from shares or securities.

1.3 Seed Enterprise Investment Scheme (SEIS)

This was launched for an initial 5 year term from April 2012. If you think EIS is risky an SEIS is an EIS on Steroids!

To qualify for SEIS status the investment ***in addition to the EIS provisions*** needs to meet the following criteria:

- A new business with less than 2 years trading
- Has less than 25 employees
- Gross assets of less than £200,000
- No previous EIS or VCT associations
- A maximum of £150,000 invested under SEIS

The investor in addition to EIS requirements must not:

- Own 30% or more of the shares
- Be an employee of the company (a director is fine)

If by some miracle you can find a business which meets all these requirements then in addition to 50% tax relief on input you will not be charged any CGT on gains which may be achieved and you can roll over gains from previous ventures.

1.4 Qualifying Underlying Investments

Many trades and professions are excluded from the beneficial EIS and VCT tax regime.

First, any company must have assets of less than £7 million prior to the new issue of shares (£8 million afterwards).

The company must be issuing new share capital.

To prevent misuse of the tax concessions, EIS relief is not granted for and VCT schemes may not hold companies who undertake the following:

- Dealing in land, commodities, futures, shares or financial instruments, shipping, steel or coal.
- Dealing in goods (other than in the course of ordinary trade of wholesale or retail distribution) banking, insurance, or other financial activities.
- Leasing, or receiving royalties or licence fees.
- Providing legal or accountancy services.
- Providing ancillary services to any of the above.
- Maximum gross assets per company of £15 million prior to investment and maximum employees in the company have to be 250.

In recent budgets (2012) there have been numerous amendments to the qualifying nature of EIS and VCT scheme underlying investments in an effort to close clever schemes which have been contrived to make use of the tax benefits without the intended investments risks.

1.5 Nominee Holdings

Anyone over the age of 18 may invest in a VCT, but they must subscribe for shares in their own name. It is, however, possible to transfer ownership to a nominee name subsequently without being treated as a disposal of the shares.

2. TAX TREATMENT AVAILABLE WHEN BUYING NEW EIS AND VCT SHARE ISSUES

The purpose of the tax reliefs is to encourage otherwise cautious investors to invest in high risk nursery companies. You do not get these benefits for nothing! It is not at all uncommon for OFEX and AIM companies to go into liquidation with no return to shareholders.

The two tax reliefs available are capital gains tax (CGT) and income tax.

2.1 CGT Deferral Relief

2.1.1 VCT

- Growth exempt from CGT.
- No allowance for losses.
- Cannot defer previous gains by rolling over.

2.1.2 EIS

- Growth exempt from CGT.
- Relief given for losses.
- Can defer previous gains by rolling over.

Unlimited amounts of gain can be deferred in any tax year if invested into a new EIS offering. The gains must be generated either 1 calendar year after the EIS investment or 3 years before the EIS investment.

It is important to note that this is a deferment of CGT, not a cancellation of it. The deferment is perhaps best explained by an example, as follows:

Shares in a PLC (without entrepreneurs relief) are sold for £500,000. The gains are calculated to be £200,000. This means that after the annual allowance the tax bill would be:

Gain	£200,000
less annual allowance	(£11,100)
Taxable gain	£188,900
tax at 28%	(£52,892)

A EIS investment of £200,000 defers all the chargeable gain and further may give the investor £60,000 tax relief (at 2016/17 rates).

After 5 years the EIS is sold for £250,000. Tax is then paid at the rate applicable in 5 years time on the original gain of £200,000 alone with no further tax to pay on the extra gain.

2.1.3 SEIS

- Growth exempt from CGT.
- Relief given for losses.
- Can exempt 50% of CGT due and defer balance of previous gains by rolling over.

Tax on gains realised on a different asset can be reduced by 50% where the disposal of that asset is during the year of the SEIS transaction.

No CGT is payable on the disposal of SEIS shares providing they have been held for three years at the time of the disposal.

If SEIS shares are disposed of at any time at a loss (after taking into account income tax relief), such a loss can be set against the investor's income or capital gains in the year of disposal or the previous year. The loss relief effectively limits the investment risk exposure to just 30p in the £1 for a 40% tax payer, or to just 27.5p in the £1 for a 45% tax payer. If the investor has also claimed the capital fains reinvestment relief, their investment risk could be reduced to just 13.5 pence in the £1.

2.2 Income Tax Relief On Purchase

2.2.1 VCTs

- Investments of up to £200,000 into VCTs will qualify for up to 30% tax relief.
- Cannot Carry back investment into previous year.
- Dividends received from a VCT are exempt from tax to the investor.

Please note our experience of VCTs is that almost without exception VCT schemes lose between 25% and 50% of their value within the first 5 years.

2.2.2 EIS

- Investments of up to £1,000,000 into EISs will qualify for up to 30% tax relief.
- Can carry back investment into previous year.
- Dividends received from an EIS are subject to tax.

Provided an EIS qualifying investment is held for no less than three years from the date of issue, or until three years from the commencement of trade, if later, an individual with no more than a 30% interest in the company can reduce their income tax liability by an amount equal to 30% of the amount invested. The minimum subscription is £500 per individual and the maximum in respect of which a subscriber may obtain income tax relief in any year is £1 million. Individuals may elect to treat their subscription for EIS shares, up to their maximum annual allowance, as if made in the previous tax year, thereby carrying back the income tax relief by one year.

All the reliefs of EIS and VCT investments are subject to the investor paying some income tax. Whilst it is highly unlikely that a non income taxpayer would make an investment of this kind, clearly such individuals should avoid these schemes.

2.2.3 SEIS

- Investments of up to £100,000 into an SEIS will qualify for up to 50% tax relief.
- Can carry back investment into previous year.
- Dividends received from a SEIS are subject to tax.

The income tax relief on a qualifying SEIS investment is calculated at 50% of the amount invested, irrespective of the tax rate of the investor. The investment must be held for a minimum of 3 years to avoid any claw-back of the relief and the investor must not hold more than 30% of the SEIS Company. The maximum investment into an SEIS is £100,000 in any one tax year.

2.3 Maximum Contributions

2.3.1 VCT

There is no longer any limit to the amount you can invest in a VCT.

30% tax relief is only granted up to £200,000 contributions.

2.3.2 EIS

There is no limit to the amount you can invest in an EIS scheme.

CGT tax deferral is available on all EIS contributions.

Income tax at 30% is available on contributions up to £1,000,000.

2.3.3 SEIS

The maximum tax efficient investment a single investor can make in an SEIS fund is £100,000.

2.4 Income Tax Treatment Of Ongoing Holdings In EIS / VCT Schemes

2.4.1 VCT Schemes

Dividends from VCTs are tax free. Having said this, the yields are frequently low and the inability to claim back advanced corporation tax (ACT) has reduced this benefit substantially.

Dividends cease to be tax free when the investor dies.

2.4.2 EIS Schemes

Dividend payments within EIS schemes are subject to income tax.

If EIS shares are disposed of at any time at a loss (after taking into account income tax relief), such loss can be set against the investor's capital gains or his/her income in the year of disposal or the previous year. For losses set off against income tax, the net effect is to limit the investment exposure to 42p in the £1 for a 40% tax payer or up to 38.5p in the £1 for a 45% tax payer. Alternatively, the losses can be offset against capital gains tax at the prevailing rate – 18% / 28%.

2.4.3 SEIS Schemes

Dividend payments within SEIS schemes are subject to income tax.

If SEIS shares are disposed of at any time at a loss (after taking into account income tax relief), such a loss can be set against the investor's income or capital gains in the year of disposal or the previous year. The loss relief effectively limits the investment risk exposure to just 30p in the £1 for a 40% tax payer, or to just 27.5p in the £1 for a 45% tax payer. If the investor has also claimed the capital gains reinvestment relief, their investment risk could be reduced to just 13.5 pence in the £1.

2.5 Tax Treatment When Shares Are Sold

The only tax consideration on sale after 3 years is CGT.

2.5.1 Claw Back Period

If the investor sells (or becomes non resident) during the 3 year qualifying period then reliefs are clawed back (with some exceptions allowed where the sale was outside the investor's control). No investor (in their right mind!) would enter into a VCT or EIS / SEIS scheme unless they were 100% confident that they could retain the investment for a minimum of 3 years after which the reliefs are usually secure.

If an EIS used solely for CGT deferment is sold, the investor then has 3 years to reinvest prior to losing their CGT deferment.

2.5.2 VCTs

Under the new regime there is no CGT on gains within the VCT and no CGT deferral hence no tax to pay. Under the previous scheme the CGT deferral tax claw back was similar to that of the EIS scheme.

We have recently been trying to sell a number of VCTs undertaken to relief CGT in the mid 90's. These have usually lost 40% of their value. It is somewhat galling to the client to then discover that if they sell the VCT they are then liable to deferred gains on the entire sale proceeds. VCT and EIS investments can also be illiquid meaning that it takes months or even years to get hold of the sale proceeds.

2.5.3 EIS / SEIS

As outlined above, deferred gains come back into account, gains within the EIS / SEIS are tax free.

2.6 Tax Treatment On Death

2.6.1 VCTs

Fall into the IHT net although there are VCTs available which distribute the AIM shares within the fund after 3 years and hence effectively generate IHT savings after 5 years.

Post death beneficiaries have to pay tax on dividends.

2.6.2 EIS / SEIS

EIS / SEIS investments into qualifying AIM shares will be exempt assets for IHT purposes after being held for greater than 2 years.

3. WOODLANDS AND FORESTRY

Forestry qualifies for 100% business property relief (BPR) once held for two years and, if held at death, there is no IHT payable on the total value of the land and trees. Any CGT liability on the asset that has been held over or rolled-over will be extinguished.

With proper professional advice woodlands, managed commercially, can provide owners with long term financial returns and can be a great tax planning investment.

3.1 Tax Free Income

Income and profits generated from the ownership of commercial woodlands is exempt from both income and corporation taxes. Forestry grants are not taxable other than annual grants under the farm woodland premium scheme (FWPS). The converse also applies however and no tax relief will be available for expenses or for interest paid on loans for the purchase or development of woodlands.

To obtain the relief you can purchase established woodlands or bare land and plant it. There are wide ranges of woodlands available to acquire, so income can be planned to suit your personal circumstances.

3.2 CGT Free Growth

The increase in the value of timber through the physical growth of trees and timber price rises is exempt from CGT. (Any increase in the value of land is not exempt but indexation relief is available.)

To obtain the CGT benefits you should consider acquiring young commercial woodland, or establish a new one, and hold it for a prolonged period. You could also consider acquiring a farm and planting the land with trees under the FWPS. This can generate a significant financial yield, an annual income and relief of all inheritance tax (IHT).

Any CGT liability incurred can be deferred by purchasing land provided that the land is considered to be a qualifying asset. Only the land will qualify, as growing timber is exempt from CGT. The deferred CGT liability can be completely extinguished if land is held until death.

3.3 IHT

Commercial woodlands (both timber and land) qualify for 100% IHT business property relief (BPR) provided they have been held for a 2 year period prior to being transferred, or on death. On a life time transfer, the donee is advised to retain the woodlands for 7 years or until the donor dies.

If you can find one, woods of special heritage value could also qualify for 100% IHT exemption.

3.4 Commercial Operation

While there is no specific guidance as to when woodlands will be regarded as constituting a business, it is important that they are run on a commercial basis with a view to realisation of profit in due course to avoid them being classified as amenity woodlands which would not attract IHT or CGT relief.

You do, therefore, have to demonstrate that your woodlands are being run on a commercial basis and are consequently relevant business property. Typically clients would:

- Enter a Forestry Commission grant scheme.
- Employ qualified managers and advisers.
- Have a long term management plan.
- Keep proper books and accounts.
- Register for VAT.

Whilst we have looked at commercial woodland on several occasions for clients, the short term investment returns have been poor. Perhaps there is less chance of “losing your shirt” than many of the other alternatives, however, you have to be prepared to invest substantial sums and to continue to pay for management and upkeep until the crop is ready to cut, often in many years time.

4. ENTERPRISE ZONE TRUSTS (EZT)

An EZT is a collective investment into property construction within an enterprise zone. Usually the property takes the form of pre-let industrial or retail units within a larger complex.

The good news about EZTs is that the investor receives full capital allowance tax relief on the construction costs of the building. As the areas of enterprise zones are usually depressed, land prices are low hence the construction costs may be in excess of 90% of the total investment.

Therefore, using a £100,000 example and a 5% land cost the tax relief might be, as its maximum, £100,000 x 95% x 40% or £38,000.

The downside to EZT investments is that to ensure the returns are tax free and the initial tax relief is retained, the investment has to be held for 25 years. There are ways around this rule (schemes do exist which seem to work with an expected redemption date of 7 to 11 years). For instance, gifting the asset to a lower taxed spouse, however, it is perhaps best to consider such schemes as very long term investments.

A recent trend for EZTs is to use syndicates of investors rather than trusts. Syndicates have the advantage of being able to obtain limited liability loans to fund the project, which makes them a deal more attractive for this loan geared tax planning project. The disadvantage of syndicates is that their minimum investment tends to be around £100,000.

The problem with EZTs or EZSs where substantial borrowing is required is that tax will be due on surplus income over interest expenditure. This means that investors will have a negative cash flow (we estimate) of about £2,750 per annum per £100,000 invested with a 61% loan. Having said this, the overall cash flow if the property is subsequently sold for a reasonable sum is very good.
We have not seen a large viable EZT scheme for several years.

5. RISK FACTORS (ALL SCHEMES)

Those of us with long memories will have very painful recollections of the early BES plans! Paying tax at 40% is painful, however, you still retain 60% of the money. A tax efficient investment that goes bust may have saved you 40% tax, but you have still lost your residual 60% of funds!

Likewise even with the new CGT regime increasing business CGT to 18%, you are probably better to pay the 18% tax and run, rather than go into further high risk operations outside your control.

Finally we have been involved in expert witness cases where the tax promises of schemes have not come to fruition. Remember a tax counsel's opinion is just that, it is not approval from HM Revenue & Customs.

5.1 Investment Risk

We have not recommended anyone of these schemes for around 5 years. If however the circumstances are right then from our own past experience and in our own subjective order of risk the above alternatives might be as follows:

5.1.1 SEIS (Very High Risk)

This is an investment into a single very small company. By definition many smaller companies fail, whilst many more do not perform. We prefer clients to use VCT legislation (which spreads their risk) unless they have detailed personal knowledge of the SEIS proposed or are making the investment as part of a larger IHT / investment planning exercise.

5.1.2 EIS (High Risk)

This is an investment into a single smaller company. By definition many smaller companies fail, whilst many more do not perform. We prefer clients to use VCT legislation (which spreads their risk) unless they have personal knowledge of the EIS proposed or are making the investment as part of a larger IHT / investment planning exercise.

5.1.3 EZT (Medium Risk But Almost Impossible To Realise Within 7 Years)

Whilst this is a collective investment, the investment is usually into a single large building. Enterprise zones by definition are not granted in thriving areas where land and property values are shooting ahead!

If the project is pre-let to a good tenant then there may be a security of income for perhaps 5 or 7 years. However, if the enterprise zone is a flop, property values after this period may sink to a fraction of the original costs of the building.

5.1.4 VCT (Medium/High Risk)

Most VCTs have between 25 and 50 separate companies within the trust. This does spread the risk of the investment and perhaps 2 or 3 might fail and the majority of the firms perform at a reasonable level. Overall, in our subjective view, VCTs are normally the lowest risk alternative for reasonable tax planning.

It is worth noting that very few VCTs are worth as much as the original investment after 5 years. (Our experience suggests between 25% and 50% losses) The tax free nature of VCTs is investor specific so it can be bad news if the investor dies and a subsequent sale is required.

6. REALISATION RISK

6.1 EZT (Minimum 7 Years, Perhaps as Much as 25 Years)

Some schemes have been marketed with agreed purchase clauses which, if honoured, do provide the investor with a means to realise their investment after perhaps 7 years.

The enterprise zone could end up a ghost town and be worthless or it could end up as prime commercial site, in which case realisation at a substantial profit will easily be achieved.

By definition, it is almost impossible for a small investor to sell their share in an EZT. These investments really are unrealisable unless the building as a whole is sold.

6.2 SEIS, EIS & VCT (Minimum 3 Years)

The tax legislation makes these investments unattractive to sell within a minimum of 3 years. By definition, if you lose your tax breaks within 3 years you tend to hold onto the investment. Likewise, would you want to buy a VCT without tax reliefs when you can purchase new offerings and benefit from 40% income tax relief? For this reason, inevitably, the price of SEIS, EIS/VCT shares tends to fall after issue. After 5 to 10 years, values can be attractive, particularly to larger funds wanting to buy in a group of smaller companies. As a general observation, however, our experience has been that VCT schemes perform poorly.

SEIS, EIS and VCT shares can be subject to a huge spread in their price dependent upon market sentiment. Quite often, simply no one wants the share and it cannot be sold.

7. RISK WARNINGS

Our regulators, the Financial Conduct Authority (FCA), require investors into these schemes to sign a risk warning that confirms you understand these investments may be unsalable or fail. For this reason, you will find a risk warning enclosed with any literature on these investments which we will require you to sign and return to us before we can accept any business of this kind.

Whilst we have done our best to explain these schemes they are highly complex and subject to changes in legislation and to interpretations of the law. You should not take any action prior to consulting your professional legal and taxation advisers. Only they will be able to advise you correctly due to their greater expertise and their existing knowledge of your personal affairs.

Please note that whilst every effort is made to ensure that the information contained within this explanation is correct, these notes are by necessity brief and of a generalised nature. Clients should seek specific personalised advice prior to undertaking any arrangement. These notes are named 10.2015 Tax Efficient Investments and was last updated in October 2015. Whilst we have done our best to ensure facts are current to this date laws and options are changing constantly so always check before action.

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